Private Equity Fund Accounting

Presenter: Caryn Maitland

From Understanding the basics to accounting for the investments

Ask Questions

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Presenter

Caryn Maitland

Caryn is a qualified CA(SA and RA, who has lectured extensively at UKZN (and other institutes) where she lectured Advanced Financial Accounting up until 2011 as well as co-ordinating the module on the Pietermaritzburg campus and was appointed Section Head of Financial Accounting and Deputy Head of the School of Accounting (managing the Pietermaritzburg campus) prior to leaving UKZN.

She has conducted independent workshops and seminars for professional accountants since 2006 on various topics and has consulted on a number of technical issues. Since January 2011, she has focused on her own business as technical freelance consultant and trainer to those working within the accounting profession. Caryn is a technical advisor to the SAICA Eastern Region Midlands District, Northern District and Southern District Associations, as well as the Small Practice Interest Group in Durban – specialising in financial reporting (IFRS, IFRS for SME's and general accounting), assurance, legislation and ethics. Caryn has a passion for Corporate Governance, which together with her Companies Act specialism and Financial Management for Non Financial Management lecturing background, has served her well in consulting and advising various Boards of Directors in recent years.

Caryn is also a platform presenter for various institutes as well as many small to medium accounting practices across the country and into Southern Africa. Maitland was appointed as a visiting Associate Professor to the University of Limpopo tasked with mentoring their Financial Accounting staff (Aug 2011 to Dec 2013).

Maitland's passion is IFRS and IFRS for SME's and was delighted at the opportunity granted in 2013 to serve on the APC subcommittee constituted to investigate the need for Micro GAAP and the role of IFRS for SME's for small and medium sized practitioners. Caryn, also serves on the Joint Accountants, Auditors and Attorneys Committee of SAICA, and is part of the School Governing Body project initiated by SAICA in KwaZulu-Natal, and has been appointed as an alternative member to the APC in June 2020

Caryn was elected as the first woman Chairperson for the Midlands District Association for SAICA in 2018 and also serves on the Eastern Region SMP Committee as well as the Local Subvention Committee for SAICA. In 2019 Caryn was appointed to the SAICA Eastern Region Council. As someone who is committed to environmental affairs, Caryn serves as a non-executive director for the Institute of Natural Resources, a Non Profit Company focusing on research. Since 2018 Caryn has worked extensively with commerce and industry, assisting analysts, directors and other users of financials to interpret, prepare, analyse and forecast based on the results of financial statements.

Course Outline

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Understanding Private Equity

Accounting for Private Equity

Valuation and Due Diligence considerations

Understanding Private Equity?

Understanding Private Equity

What is Private Equity (PE)?

The Private Equity Profession

Types of Private Equity Firms

How Private Equity creates value

Private Equity Investment Strategies

Oversight and Management

Private Equity and Crowdfunding

What is Private Equity?

- Private equity (PE) is
  - ownership or interest in an entity that is not publicly listed or traded
  - A source of investment capital,
- Private equity (PE) comes from high-net-worth individuals (HNWI) and firms that
  - purchase stakes in private companies or
  - acquire control of public companies with plans to take them private and/or delist them

What is Private Equity?

- The private equity (PE) industry is comprised of
  - institutional investors such as pension funds, and
  - large private equity (PE) firms funded by accredited investors.

- Private equity (PE) entails direct investment often to gain influence or control over a company's operations—a significant capital outlay is required

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- Private equity (PE) entails direct investment often to gain influence or control over a company's operations—a significant capital outlay is required
- The underlying motivation for such commitments is the pursuit of achieving a positive return on investment (ROI).
- Partners at private equity (PE) firms raise funds and manage these monies to yield favorable returns for shareholders, typically with an investment horizon of between four and seven years.

The Private Equity Profession

- Require Accounting and legal skills are necessary to complete deals and transactions
- The fee structure for private equity (PE) firms varies but typically consists of a management and performance fee.
    - A yearly management fee of 2% of assets and 20% of gross profits upon sale of the company is common, though incentive structures can differ considerably
- Assets Under Management – AUM
    - Total market value of the investments that a person or entity handles on behalf of investors

Types of Private Equity Firms

- Private equity (PE) firms have a range of investment preferences.
- Passive vs Active investors
    - Strict financiers or passive investors are wholly dependent on management to grow the company and generate returns.
    - Other PE firms consider themselves active investors. That is, they provide operational support to management to help build and grow a better company.
- Active private equity (PE) firms may have an extensive contact list and C-level relationships, such as CEOs and CFOs within a given industry, which can help increase revenue.
- They might also be experts in realizing operational efficiencies and synergies.
- Investment banks
    - compete with private equity (PE) firms, also known as private equity funds, to buy good companies and to finance nascent ones.
    - In the case of private equity (PE) firms, the funds they offer are only accessible to accredited investors and may only allow a limited number of investors, while the fund's founders will usually take a rather large stake in the firm as well.

Types of Private Equity Firms

- Private equity (PE) firms have a range of investment preferences.
- Passive vs Active investors
    - Some are strict financiers or passive investors wholly dependent on management to grow the company and generate returns. Because sellers typically see this as a commoditized approach,
    - other private equity (PE) firms consider themselves active investors. That is, they provide operational support to management to help build and grow a better company.
- Active private equity (PE) firms may have an extensive contact list and C-level relationships, such as CEOs and CFOs within a given industry, which can help increase revenue.
- They might also be experts in realizing operational efficiencies and synergies. If an investor can bring in something special to a deal that will enhance the company's value over time, they are more likely to be viewed favorably by sellers.
- Investment banks
    - compete with private equity (PE) firms, also known as private equity funds, to buy good companies and to finance nascent ones.
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How Private Equity Creates Value

- Private-equity (PE) firms perform two critical functions:
  - Deal origination/transaction execution
  - Portfolio oversight
- Deal origination
  - involves creating, maintaining, and developing relationships with mergers and acquisitions (M&A) intermediaries, investment banks, and similar transaction professionals to secure both high-quantity and high-quality deal flow:
  - prospective acquisition candidates referred to private equity (PE) professionals for investment review.
  - Some firms hire internal staff to proactively identify and reach out to company owners to generate transaction leads. Additionally, internal sourcing efforts can reduce transaction-related costs by cutting out the investment banking middleman's fees.
  - When financial services professionals represent the seller, they usually run a full auction process that can diminish the buyer's chances of successfully acquiring a particular company.
- It is important to note that investment banks often raise their own funds, and therefore may not only be a deal referral, but also a competing bidder

How Private Equity Creates Value

- Transaction execution involves
  - assessing management, the industry, historical financials and forecasts, and conducting valuation analyses.
  - After the investment committee signs off to pursue a target acquisition candidate, the deal professionals submit an offer to the seller.
- If both parties decide to move forward, the deal professionals work with various transaction advisors, including investment bankers, accountants, lawyers, and consultants, to execute the due diligence phase.
- Due diligence includes validating management's stated operational and financial figures.
- This part of the process is critical, as consultants can uncover deal-killers, such as significant and previously undisclosed liabilities and risks.

Private Equity Investment Strategies

- Two of the most common are leveraged buyouts (LBOs) and venture capital (VC) investments.
- **Leveraged Buyouts (LBOs)**
- LBOs are exactly how they sound. A company is bought out by a private equity (PE) firm, and the purchase is financed through debt, which is collateralized by the target's operations and assets.
- The acquirer (the PE firm) seeks to purchase the target with funds acquired through the use of the target as a sort of collateral.
- In an LBO, acquiring private equity (PE) firms are able to assume control of companies while only putting up a fraction of the purchase price.
- By leveraging the investment, PE firms aim to maximize their potential return.
- PE firm would secure debt in their books which is secured by the investment in the targeted company.
    - The return from the investment is anticipated as being greater than the cost of debt

Private Equity Investment Strategies

- **Venture Capital (VC)**
- VC is a more general term, frequently used in relation to taking an equity investment in a young company in a less mature industry
- Private equity (PE) firms will often see that potential exists in the industry and more importantly in the target firm itself, noting that it's being held back, say, by a lack of revenues, cash flow, and debt financing.
- Private equity (PE) firms are able to take significant stakes in such companies in the hopes that the target will in its growing industry.
- Additionally, by guiding the target's often inexperienced management along the way, private-equity (PE) firms add value to the firm in a less quantifiable manner as well.
- Playing the long game, investment when the value is low with the prospect of capital growth

Oversight and Management

- Oversight and management make up the second important function of private equity (PE) professionals.
- Assist a young company's executive staff through best practices in
  - strategic planning and financial management and
  - institutionalize new accounting, procurement, and IT systems
- For more established companies, PE) firms have the ability and expertise to take underperforming businesses and turn them into stronger ones by increasing operational efficiencies, ,impacting earnings.
- This is the primary source of value creation in private equity
  - also create value by aiming to align the interests of company management with those of the firm and its investors.
- Do they work with listed companies???
- Impact of managing management’s compensation on performance..
- Increasing the target company’s value from the time it was purchased, creates a profitable exit strategy for the private equity (PE) firm if required

Private Equity and Crowd Funding

- Private equity crowdfunding allows companies or entrepreneurs to obtain financing. The investor is offered debt or equity in exchange for partial ownership of the business. Oftentimes, private equity crowdfunding is shortened to the term equity crowdfunding.

- Crowdfunding can be used by companies to raise money, similar to how individuals can raise money for causes via GoFundMe. Examples of online platforms for equity crowdfunding include Wefunder, AngelList, Crowdfunder, SeedInvest, and CircleUp.

- With private equity crowdfunding, however, entrepreneurs and businesses generally have to give up equity to get the investment.

Accounting For Private Equity

Accounting For Private Equity

Financial Instruments – Investments in shares

Loan receivables and impairments

Leveraged buy outs and debt consequences

Consolidation issues

Agent vs Principal

Financial Instruments – Investment in Shares

- IFRS vs IFRS for SME's
- Fair value accounting
  - Through P&L or Equity??
- Speculative???
- Valuations

Loans Receivables

- Capital investments
- Impairments – ECL
- Subordination consequences
- S45 Financial Assistance issues

General Formula for Expected Credit Losses

ECL = PD x EAD x LGD

- Probability of Default (PD)
  - Risk that that borrower will be unable or unwilling to repay its debt in full or on time
- Exposure at Default (EAD)
  - The GROSS exposure under a facility upon default of a borrower
  - In general, seen as an estimation of the extent that a lender may be exposed to a counter party in the event of that counter party's default
  - Equal to current amount outstanding for fixed exposures, unsecured receivables = full balance
- Loss given default
  - Share of an asset that is lost when an asset defaults

Leveraged Buy Outs and Debt Consequences

- Solvency and Liquidity issues
- Underperforming investments
    - ROI vs cost of Debt

Consolidation issues

- Foreign operation issues??
- Do you have control?
- Business Combinations
- Investment Holding Entity

Agent vs Principal

- Revenue recognition
- Portfolio management
- Management fees
- Shared services

Valuation and Due Diligence

Valuation and Due Diligence

Valuation technique

- Net Asset Value
- Discounted Cash Flow
- Maintainable Earnings
- Earnings before interest, tax, depreciation and amortization (EBITDA)

Due Diligence and negotiations

Due Diligence

- Compatibility audit
- The four elements
- Why is due diligence necessary?
- Types of due diligence engagements
    - Financial due diligence
    - Macro-environment due diligence
    - Legal due diligence
    - Marketing due diligence’
    - Production due diligence
    - Management due diligence
    - Information system due diligence
    - Risk due diligence
- The due diligence engagement
- Due diligence vs Auditing
- Other considerations
- Deal breakers

The four elements

Due diligence covers the following four elements

- The examination of a potential target
- A reasonable investigation – focus on material matters
- An examination – asking key questions:
    - Do we buy?
    - How do we structure the acquisition?
    - How much do we pay?
- An examination – decide the valuation and shareholder valuation methods

The four elements

- Understand the client – acquire knowledge of the business
  - Management style
  - Do they work well in a team?
  - Enthusiastic or have a personal concern?
- Establish facts
- Superior information is a crucial advantage in the negotiation process
- Warranties does not offer sufficient protection
- Finding issues (not really deal breakers) to be used in price negotiations
- Restructuring the transaction (buying shares vs assets)
- Cancelling the deal altogether
- Assisting with the preparation of a sale and purchase agreement

Valuations

Basic ingredients needed

- Cash flows or future benefits

- Discount rate or rate of return

Risk – Return Relationship

- Impact of return on value

- Impact of risk on value

- Valuation by comparing rates of return

8 Part Framework to Presenting a Valuation Solution

- Determine the objective to be achieved
- Identify the rights and obligations attaching to ownership (control and significant influence)
- Choose an appropriate valuation method – justify
- Identify future benefits
- Determine the risk adjusted discount rate
- Arrive at the valuation by discounting the future benefits at the risk adjusted discount rate
- Reasonableness check – use alternative method
- Conclude

Q&A

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If you would like to e-mail a question please use:

technicalquestions@accountingacademy.co.za

Thank you for your participation